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Why directors must take responsibility for intellectual property

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Why directors must take responsibility for intellectual property

Boards of directors in the US that leave IP decisions to management without appropriate board oversight may unwittingly create substantial risk. In addition to subjecting their company to potential litigation and liability, they may also face significant personal exposure

By **Robert Sterne** and **Trevor Chaplick**

Intellectual property management is not often considered a primary issue for oversight by boards of directors. Generally delegated near exclusive authority over IP matters, management may provide IP reports to boards infrequently or, worse, only when litigation is on the horizon. But the current corporate governance climate in the US imposes higher expectations for board oversight and more risk of personal liability when directors get it wrong. This increased fiduciary responsibility comes at a time when the value of IP assets and the magnitude of liability in IP litigation have never been greater, particularly for technology companies. These trends strongly suggest that boards revisit their policy of IP oversight. No longer may a board assume that it is safe to delegate IP matters completely to management.

This article explores the fiduciary responsibilities of directors for the oversight of IP assets, a topic that has received surprisingly little attention. The standard of director care and practical bases of liability are outlined, followed by a discussion of case law trends and the impact of Sarbanes-Oxley. An analysis of risks related to IP litigation is then presented with a discussion of directors and officers (D&O) insurance coverage and corporate indemnification limits. The article concludes by discussing best practices with suggestions for IP oversight that should help minimise liability.

Case law

What is the legal standard of director conduct for oversight of a company's IP assets in the US? Given the importance of IP assets, particularly in the technology industry, are directors subject to greater fiduciary duties and associated liability exposure for failure of oversight of IP assets? Delaware law is used as a baseline because its corporate case law is well-developed and influential on a national level.

As a general matter, lawsuits against directors for improper or inadequate oversight generally seek to find a breach of fiduciary duty. Delaware case law does not impose a different standard on director oversight responsibilities of IP assets. The analysis of director liability for breach of fiduciary duty begins with the business judgment rule. The rule provides a presumption in favour of directors, and a court will not second-guess board actions unless the requirements for the presumption have not been met.

Eligibility for protection under the business judgment rule requires that directors act on an informed basis, in good faith and in the honest belief that the action taken is in the best interest of the corporation. A court will respect a board's decision unless the directors are interested or lack independence relative to the decision, fail to act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process. As a matter of practice, it is difficult for plaintiffs to overcome the business judgment rule where boards have followed good process such as taking adequate steps to inform themselves and ensuring such decisions are made by disinterested, independent directors. In such cases, a court will generally not review a board's actions for breach of fiduciary duty unless gross negligence can be shown, a difficult standard for plaintiffs to meet.

While the business judgment formulation applies to affirmative board decisions, in the

event loss is caused by board inaction or failure of oversight, the Delaware courts generally apply the standard articulated in the landmark case *In re Caremark International Inc Derivative Litigation* (698 A2d 959 (Del Ch 1996), Caremark was in the business of providing patient and managed care services. The plaintiffs alleged that the board failed to exercise appropriate attention and thereby breached its duty of care by allowing the company to enter into agreements with doctors in violation of federal Medicare reimbursement laws which led to certain adverse regulatory action against the company. The *Caremark* court held that a board has an obligation to stay reasonably informed concerning the corporation and consequently has a good faith duty to ensure that an adequate corporate information and reporting system exists. An adequate information and reporting system should ensure that management and the board receive accurate and timely information in order to reach informed decisions concerning business performance and compliance with law.

Although *Caremark* imposes on directors the duty to ensure that adequate monitoring systems exist, in practice it has been difficult for plaintiffs to convince courts to hold directors liable for breach of this duty for two reasons:

- The level of detail that constitutes an adequate reporting system is a matter of business judgment, meaning that courts will generally defer to the considered judgment of a disinterested and independent board.
- The *Caremark* court enunciated a relatively high standard for breach of this duty. In the event of a claim based on alleged ignorance of activities creating corporate loss, only a "sustained or systematic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reasonable information and reporting system exists – will establish the lack of good faith that is a necessary condition of liability." Thus, for there to be a realistic risk of director liability under the *Caremark* standard, the directors' failure of oversight must be so great as to constitute bad faith.

It is notable that the *Caremark* court held that that there was no evidence that the directors were guilty of a "sustained failure to exercise their oversight" function. While the *Caremark* decision initially provoked significant attention and concern for increased liability exposure, commentators have observed that the case has not had the impact originally projected. The *Caremark* court itself observed that a claim for failure to monitor "is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment".

Subsequent cases have borne out this prediction with relatively few holdings of liability for violations under *Caremark*. Illustrative of the high standard before liability may attach under *Caremark*, in *Pereira v Cogan* (294 BR 449, 532-33 (Bankr SDNY 2003)), the court found that the board's failure to set up procedures to monitor and manage loans to corporate employees or even discuss whether controls needed to be put in place was a "grave inattention" that violated the duties of care and loyalty. In this case, the court found liability because the board had completely failed to initiate and maintain adequate monitoring systems. Previously, in *In re Oxford Health Plans Inc* (192 FRD 111 (SDNY 2000)), the court found the plaintiffs had satisfied the demand futility requirement by making specific allegations regarding lack of sufficient financial controls and procedures to monitor a conversion to a new computer system and appropriation of company assets by directors. In several other cases finding potential *Caremark* liability, courts cited obvious red flags such as government investigation into the company as signals that the directors had ignored, thereby failing to fulfill their duty of oversight. Directors have a duty to follow up when such red flags are raised. In virtually all cases in which the potential for liability has been found under *Caremark*, plaintiffs have been able to allege egregious facts indicating a failure of board oversight.

Another possible theory of liability against a board for failure to manage IP is the doctrine of waste. Delaware law tasks directors with managing the assets of the corporation and, theoretically, if a company has failed to take action to preserve the value of its IP by, for example, failing to file timely patents or to enforce valuable rights, directors could be subject to a waste claim. In practice, such suits have not been brought; the focus of waste claims is instead on affirmative action in the form of asset transfers, compensation or stock option grants, rather than board inaction for failure to properly preserve asset value. Directors are only liable for waste when "what the corporation has received [in return for an asset transfer] is so inadequate in value that no person of ordinary, sound business judgment would deem it worth what the corporation has paid" (*Saxe v Brady*, 184 A2d 602, 610 (Del Ch 1962)). Because waste claims under Delaware law are extremely difficult and because they almost always involve cases of

board action rather than neglect, the possibility of a waste claim based on IP assets should not overly trouble board members at the present time.

So what is the likely basis for director exposure for a board's oversight of IP? The recent derivative litigation against the directors of the Walt Disney Company suggests that the angle of attack may be a showing of bad faith by directors in the failure to exercise due care. In *In re The Walt Disney Co Deriv Litig*, 825 A2d 275 (Del Ch 2003), shareholders filed a derivative action against Disney directors alleging breach of fiduciary duties in the hiring and subsequent termination of employment of Michael Ovitz as president of the company. According to the pleadings, the compensation committee did not review Ovitz's draft employment agreement prior to meeting, and even at the meeting received only a summary of the agreement's terms and conditions. It spent less than an hour deliberating before approving the hiring of Ovitz. It directed Michael Eisner, Disney's CEO and Ovitz's close friend, to negotiate the details of the contract. The full board's meeting occurred immediately after the compensation committee's meeting and was equally cursory. No expert consultants were present at the meeting to advise the board. Ovitz negotiated his later departure from Disney solely with Eisner, which resulted in termination benefits from Disney allegedly in excess of US$140 million. Even after the agreement was made public, the board never attempted to ask why it was not informed, ask about the terms and conditions of the agreement, or delay termination in order to obtain further information.

Based on the pleadings in the amended complaint, the court ruled that the facts as alleged suggested that the Disney directors consciously and intentionally disregarded their fiduciary duties in determining the terms of the compensation and the subsequent termination of Ovitz. The chancery court denied a motion to dismiss by defendants. Thus, the court held in part that the plaintiffs sufficiently alleged a breach of the directors' duties to act honestly and in good faith, and the directors' actions thereby fell outside of the presumption of the business judgment rule.

If the practical standard of director liability from a breach of fiduciary duty in the oversight function is a showing of bad faith – in other words an extreme breakdown in the exercise of due care – is the real world level of exposure low for boards in connection with the oversight of IP assets? Perhaps, but the financial and business risks from IP disputes and infringement actions can be enormous.

Consider the recent judgment against Research in Motion (RIM) that was upheld on appeal by the US Court of Appeals for the Federal Circuit *NTP Inc v Research in Motion, Ltd*, 2004 US App LEXIS 25767 (Fed Cir Dec 2004). The court upheld in part a potentially devastating judgment of the lower court entered in favour of NTP Inc against RIM following a jury verdict that RIM's Blackberry system infringed various NTP patents. The lower court awarded damages to NTP of US$53.7 million and imposed on RIM an obligation to pay an ongoing royalty of 8.55% of all Blackberry sales in the US. The lower court issued a permanent injunction barring RIM from manufacturing or selling Blackberry devices and services in the US, the foundation of its business. The court on appeal stayed the injunction pending the outcome of proceedings on remand to the lower court. If RIM does not succeed, the injunction will be reinstated. While it is unlikely such an injunction would cause it to cease US operations, RIM would probably face an extremely costly settlement and on-going royalty payments to NTP.

Although its stock price has remained relatively constant following the announcement of this verdict, RIM created a reserve of US$58.6 million in fiscal year 2003 and US$35.2 million in fiscal year 2004, significant figures compared to its current year revenues of US$595 million. Notwithstanding the lack of precipitous stock price drop, given the magnitude of the potential settlement cost and royalty obligations to NTP, it is possible that the RIM verdict ultimately could precipitate shareholder litigation against RIM. Query whether any such case would involve claims for breach of director fiduciary duties. While RIM is a Canadian corporation and therefore subject to Canadian law on the issue of director fiduciary duties, were the RIM directors' actions nevertheless sufficient to meet their fiduciary duties? If a similar verdict were issued against a Delaware corporation based on analogous facts, would the directors face exposure? When judged in hindsight, particularly given the magnitude of the potential settlement, it would not be surprising for a Delaware court to deny a motion to dismiss by a company facing a similar significant IP liability if there were sufficiently pleaded allegations of director gross negligence rising to the level of a failure to act in good faith as in the case of the Ovitz litigation.

Sarbanes-Oxley implications

The well publicised corporate failures following the end of the stock market boom in 2000 produced a legislative response in the

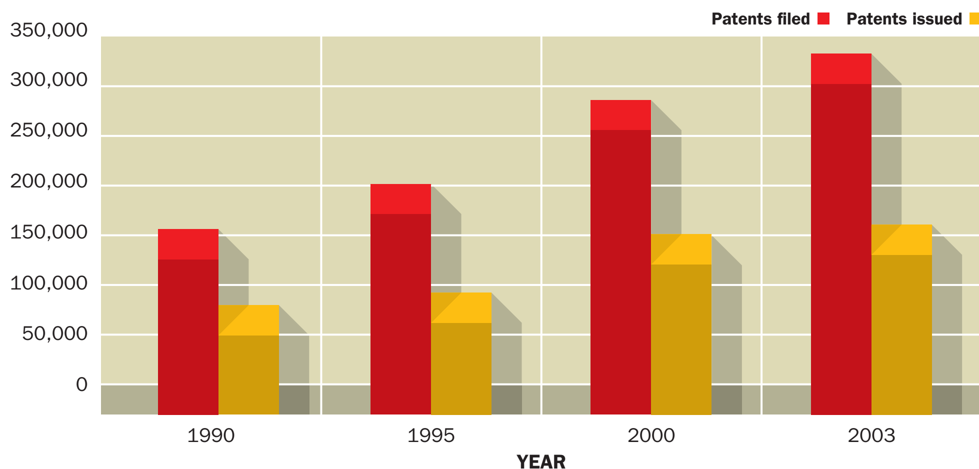
Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) which imposes stricter process and reporting requirements on public companies. As directed by Section 404 of Sarbanes-Oxley, the Securities and Exchange Commission (SEC) requires public companies to include in their annual report a report of management on the company's internal control over financial reporting. Auditors of public companies must attest to and report on management's assessment of their internal control over financial reporting. Public companies must disclose in their quarterly and annual reports the conclusions of such officers about the effectiveness of the company's disclosure controls and procedures. In addition, Sections 302 and 906 of Sarbanes-Oxley require the principal executive and financial officers of such companies to provide certain certifications in each quarterly and annual report.

What effect does Sarbanes-Oxley have on the fiduciary duties of boards of directors concerning IP risks and losses? Certainly Sarbanes-Oxley underscores the importance of effective internal controls. In fact, the new standards under Sarbanes-Oxley go well beyond the requirements of *Caremark*. However, the focus of the internal control rules under Section 404 is on internal control over financial reporting. In adopting the final rule to implement Section 404, the SEC declined to accept a more expansive definition of internal control urged by certain commentators that not only would include financial reporting, but also would focus on enterprise risk management and corporate governance. According to Release 33-8238 of 3rd June 2003, the SEC believes that the focus of Section 404 is limited to "internal control over financial reporting". It should be noted that under Item 307 of Regulation S-K, management has an obligation to disclose their conclusions regarding the effectiveness of "disclosure controls and procedures", a definition that substantially overlaps with the definition of "internal control over financial reporting" but involves controls and procedures designed to ensure that all information required to be included in reports filed with the SEC is properly reported.

Certainly an IP matter that is required to be reflected in a public company's financial statements, such as a material expense and associated liability for IP infringement, would implicate Section 404. Similarly, Item 307 of Regulation S-K would be implicated if a disclosure is required in a report to be filed with the SEC regarding an IP matter such as the commencement of material IP litigation against a company. However, without an obligation to reflect information in financial statements or a legal duty otherwise to disclose an IP-related matter under the SEC's rules and regulations, it is not clear that Sarbanes-Oxley has produced any new burdens on boards specifically related to the oversight of IP. Generally, a public company board must exercise care in oversight to ensure that its company's internal control over financial reporting and disclosure controls and procedures are sufficiently effective to ensure timely and accurate disclosure of all information required to be reported under federal law. To the extent such controls are ineffective to ensure required disclosure of IP matters, a failure of oversight may exist.

Thus, while Sarbanes-Oxley imposes a greater burden to maintain effective controls to ensure accurate and timely disclosure, we do not believe it imposes any different requirements for IP issues than any other disclosure matter. Nevertheless, given the wider scope of internal control requirements under Sarbanes-Oxley, it may be easier for plaintiffs to demonstrate a *Caremark* breach to the extent material weaknesses exist in a company's internal controls. If a company experiences a material loss from an IP risk and has not accurately disclosed such risk in a timely manner due to inadequate controls, a board could face greater exposure.

Chart 1
Utility patents filed and issued in the US



Directors' personal liability

The certificate of incorporation of many Delaware companies allows the company to indemnify directors from any personal liability, as provided in Section 145(a) of the Delaware General Corporation Law. However, Section

145(a) only permits indemnification for actions made in good faith and Section 102(b)(7) specifically prohibits corporations from limiting or eliminating liability "for acts or omissions not in good faith". Directors should be aware that *Caremark* claims alleging that they failed to monitor adequately or failed to follow up on red flags signalling possible misconduct in the company can constitute bad faith and therefore may cause such directors to be ineligible for indemnification by the company. This possibility increases the risk of personal liability for the director.

Delaware law gives companies the authority to purchase D&O insurance coverage to reimburse directors for personal losses for which they are not indemnified by the company. Arguably these policies would cover *Caremark* claims of lack of oversight by the board; typically they contain exclusions relating to active deliberate or wilful dishonesty, which would seem to require affirmative action rather than the inaction that is the essence of the *Caremark* claim.

Directors should keep in mind, however, that when losses are great, it is natural for a carrier to contest coverage based on a strict interpretation of the policy terms and conditions. Directors who fail to oversee their companies' IP assets adequately should be aware that indemnification from the company itself may not be allowable under state corporate law and that D&O coverage, even if available, may not be sufficient to cover the amount of claims. The recent Enron and WorldCom settlements, discussed in greater detail below, signal a new appetite for plaintiffs and the SEC to hold directors personally accountable for perceived missteps.

IP risk factors

Prior to the last 10 years, the degree of attention on IP protection varied greatly by industry sector. In the last decade, these disparities have narrowed. Leading players in most industries today are extremely sensitive to IP issues. These companies concentrate on filing and obtaining patents worldwide, and diligently protect and enforce trademark, trade secret and copyright assets. A recent Interbrand survey, for example, claims that trademarks helped the top 10 companies featured in the study to generate a total of US$381 billion in brand-driven revenues in 2003.

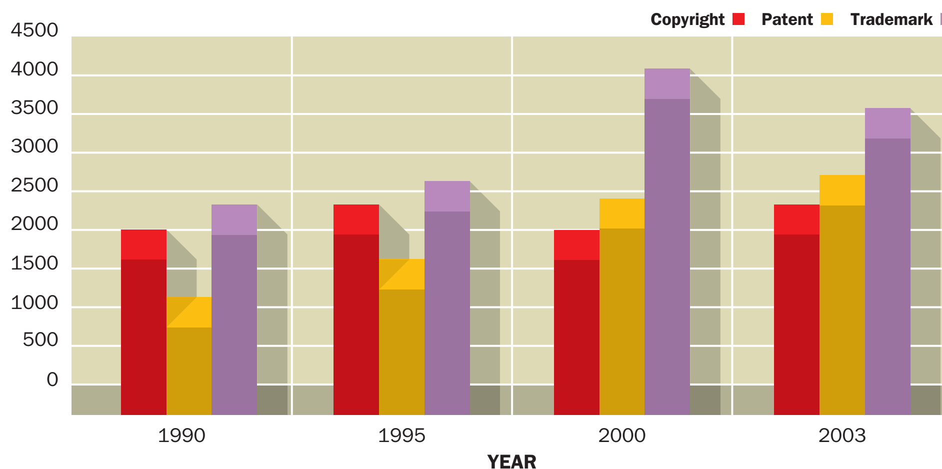
The role of IP in certain industry sectors was much less prominent a decade ago. In electronics this was particularly true. Mechanical technology placed only moderate importance on IP for a variety of historical and market reasons. The consumer products industry generally emphasised IP in certain sectors where there was a niche or high profits. In contrast, the pharmaceutical and chemical sectors have always placed high importance on IP. Keying off these industries, the biotechnology and medical device sectors have embraced IP from their beginnings. The emerging sectors of bioinformatics and nanotechnology have followed suit.

Today all industry sectors embrace IP. Even service industries have become IP conscious, especially since the Federal Circuit *State Street Bank & Trust Co v Signature Financial Group Inc* (149 F3d 1368 (Fed Cir 1998)) decision in 1998 upholding the viability of business method patents in the financial product and services industries. Many service corporations are seeking patents to protect innovative methods and processes.

In short, IP protection, especially patents and trademarks, has become increasingly important in most industry sectors in the United States. This is demonstrated in the rise of IP litigation costs. According to an article published in the January 2005 issue of *IP Law and Business*, in 2003 companies having at least US$10 billion in revenue saw overall legal costs rise 6%, but IP litigation costs rose 32%. The importance to US companies of maintaining IP protection through patents and other IP rights is reflected in the skus and charts published on pages 19-22. These skus show a dramatic increase in both expenditures and enforcement activity to protect IP assets and in challenges to IP rights.

The first sku, as shown in Chart 1, reflects the number of utility patents filed and issued

Chart 2
Copyright/patent/trademark lawsuits filed in the US



in the US per year. In 1990 164,558 were filed and 90,365 granted; in 1995 this had risen to 212,377 filed and 101,419 granted; by 2000 the figures were 295,926 and 157,495 respectively; while in 2003 they were 342,441 and 169,028. The trend in the number of applications filed and patents issued, therefore, has almost doubled in 13 years (see http://www.uspto.gov/web/offices/ac/ido/oeip/taf/us_stat.p).

The second sku, in Chart 2, reflects the number of copyright/patent/trademark lawsuits filed in US district courts:
1990 – 2078/1238/2422;
1995 – 2417/1723/2726;
2000 – 2050/2484/4204;
2003 – 2448/2814/3672. While copyright litigation has been relatively constant, the upward trend in the number of patent and trademark suits has been dramatic (see; http://www.uscourts.gov/judicialfactsfigures/table2.15.pdf).

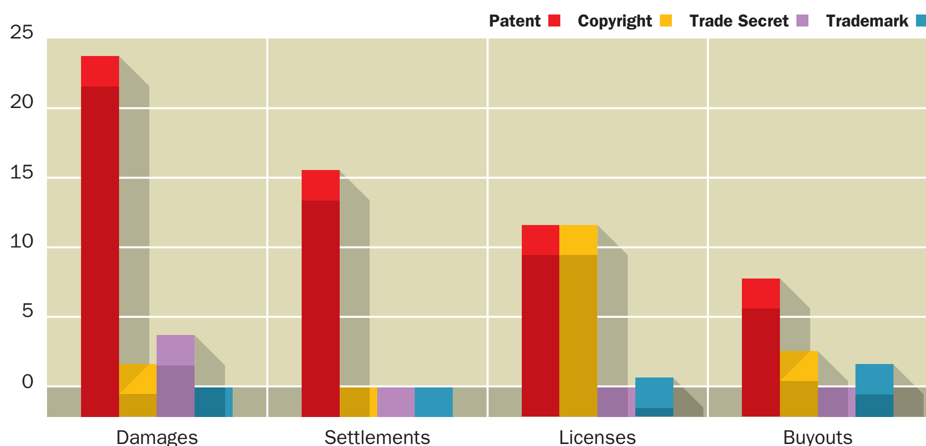
Another relevant data point for this second sku is the number of investigations by the US International Trade Commission (ITC) under §337 of the Tariff Act of 1930 (19 USC 1337), which offers more extensive remedies against infringing imports than federal courts offer because of the ITC's technical capabilities, the detailed discovery available, the favourable nationwide relief often obtained and the fast-paced schedule at which the agency works. ITC investigations have increased substantially over the last few years, 50% in the last year alone. If one patented claim is found valid and infringed upon, a company may face having its products stopped at the borders – a potentially devastating effect for companies with a limited number of major products.

The third sku includes representative reported damage awards, settlements, licences and buyouts in patent, copyright and trademark litigation and trade secret misappropriation in excess of US$100 million since 1990 based on our own research. This data is based on several comprehensive lists of yearly top damage and settlement amounts and a comprehensive list going back over a decade of the largest IP damage awards, settlements, buyouts, and license deals. Through these lists, we have identified the following data on patent actions (largest of each type is in parentheses): 24 damage awards (US$900 million), 16 settlements (US$500 million), 12 licences (US$330 million) and eight buyouts (US$1 billion). In regard to copyrights, which also can carry criminal liability, we have identified the following: two damage awards (US$136 million), 12 licences (US$2.5 billion) and three buyouts (US$820 million). In the area of trade secret misappropriation, we have identified four damage awards (US$265 million). Note that these violations also carry criminal liability and have led to loss of substantial governmental contracts. In regard to trademark infringement, which also can carry criminal liability, we have identified one licence (US$187 million) and two buyouts (US$137 million). All research resources are listed in the box at the end of this article.

Based on the above information, Chart 3 reflects a summary of the total number of patent, copyright, trade secret and trademark cases having damage awards, settlements, licences and buyouts over US$100 million and Chart 4 reflects the highest dollar amount of patent, copyright, trade secret and trademark damage awards, settlements, licences, and buyouts.

The fourth sku is the premature loss of patent protection for a valuable proprietary product or service. This arises in the electronics industry when injunctions against infringement and misappropriation can cause drastic changes in websites or force the complete shut down of a website. In the pharmaceutical industry, if an unexpired patent of a blockbuster drug is found invalid, unenforceable or not infringed under ANDA litigation brought under the Hatch/Waxman Act, premature loss of patent protection can create not only the loss of very valuable rights but public relations issues such as those seen recently with the products of Prozac, Oxycontin and Prilosec. As another example, in a current patent litigation Ranbaxy Laboratories Limited is attacking the base

Chart 3
Total number per category over US$100 millions



patent of Pfizer Inc for its Lipitor drug, which according to some forecasts could cost Pfizer US$10 billion a year in lost revenues if the company prematurely loses its patent protection. As the company that proved invalidity, Ranbaxy would have the exclusive right to sell a generic form of Lipitor for six months, giving it an opportunity to earn potentially huge amounts of revenue.

Premature loss of patent protection has also occurred in the areas of stents, pacemakers and surgical devices. Examples are *Scimed Life Sys v Johnson & Johnson* (2004 US App LEXIS 510 (Fed Cir Jan 14 2004) (nonprecedential)), in which two of Scimed/Medinol's patents for balloon expandable stents were ruled invalid; and *Medtronic Inc v Intermedics Inc* (799 F2d 734 (Fed Cir 1986)), in which Intermedics' patent for a pacemaker was ruled invalid.

IP problems pose significant, if not devastating, financial and business risks to corporations today. They can match or exceed other high-risk areas such as environmental, product liability, regulatory and employment. In some cases, IP liability can expose businesses to bet-the-company litigation. Innovative upstarts can face stiff IP obstacles from entrenched, older competitors with substantial IP portfolios. Patent licensing entities can also extract significant royalties. Injunctive relief can exclude an infringing corporation from a product area or result in enhanced damages or attorney fees paid to the patent owner. A poor IP strategy or execution over time can produce a significant drop in shareholder value. This drop can be precipitous if the market does not expect such a development.

Proposed IP board strategy

The board's IP strategy must balance competing considerations that are not always easily reconcilable. The board has traditionally delegated the IP responsibility to senior management. IP is a very complex, nuanced area with critical judgment calls and highly confidential, and often privileged, information. The board does not want to usurp the prerogatives of senior corporate officers or engage in nitpicking oversight of the IP function. However, as discussed above, the board has a fiduciary duty to devote sufficient oversight to the management of IP assets.

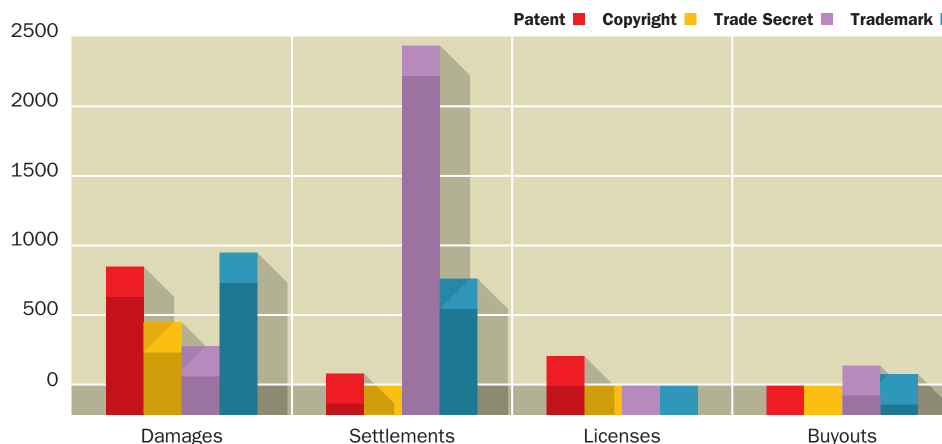
If they satisfy the requirements of the business judgment rule, directors can substantially reduce liability exposure. Public company boards under Sarbanes-Oxley must also ensure adequate controls exist to satisfy their Section 404 obligations and comply with public reporting requirements. Material breakdowns in controls over IP or disclosure deficiencies may have implications for these obligations. Nevertheless, boards should avoid self-imposed oversight responsibilities that go beyond what is required and sensible. Boards that create an internal record of overly extensive, internal oversight responsibilities may unwittingly make it easier for plaintiffs to demonstrate that a board has failed to meet its own internal responsibilities. An expected standard of care that is too high can be used against a corporation, thereby exposing it to increased IP or shareholder liability.

As discussed above, in meeting a board's oversight IP responsibilities, the board may be exposed to highly confidential information of the corporation, which may also be entitled to attorney-client privilege and/or work product immunity. Unnecessarily active board oversight in this context could actually backfire in certain circumstances, such as when a board gains too much knowledge, which can sometimes create waiver of privilege or immunity and/or create a possible finding of wilfullness, which can lead to exposure to treble damages. Careful attention should be paid to how minutes or other corporate documentation are drafted, as well as who is present at board meetings. For example, the presence of board observers in many states could cause loss of attorney-client privilege. Further, outside board members may be exposed to confidential information that puts them in a possible conflict of interest position. Depending on the circumstances, certain board members should absent themselves to avoid such potential conflicts.

In light of these considerations, a one-size-fits-all strategy for IP oversight is not realistic. At

Chart 4

Highest dollar amounts per category in US$ millions



a minimum, board members should recognise that IP is a potential high-risk area that can no longer be delegated solely to management without sufficient board-level oversight. A board should have regular IP updates at board meetings, and the board minutes and other corporate records should reflect these updates. Board IP bulletins may be warranted between scheduled board meetings, and special board meetings may need to be called if specific IP issues are time-critical and warrant such review. The audit committee may be tasked with this IP oversight function and could then brief the full board in executive session with counsel as appropriate. Since IP law is complex and rapidly changing, director education seminars on IP may be useful. Benchmarking of IP activity of competitors (such as number of patents issued per measurement period normalized for revenue, profits or other metric) may be needed to support management's IP strategy. Periodic meetings with inside and/or outside IP counsel may be advisable. All in all, it must appear to an outside observer that the board has engaged in reasonable involvement with the IP strategy and execution of strategy by the corporation.

Briefing the board and possible waiver and conflict

Management should work together with corporate and IP counsel, and perhaps the audit committee if tasked with IP oversight by the board, to set the parameters of the IP agenda for board meetings. Both overall IP strategy and specific IP issues and disputes may need to be addressed. Potential topics include: budgets and reserves, assessments of the proprietary position of key products and services as well as freedom-to-operate issues, competitive analysis of IP position and enforcement by competitors, and legal developments and industry trends in IP.

Waiver of attorney-client privilege and/or work product immunity can occur in IP disputes, especially if litigation has been instituted. What constitutes a waiver varies with state law. Under general corporate law rules, board meeting discussions and resulting minutes or other written records are not privileged unless legal advice is being sought or rendered and counsel leads the discussion. It is probably prudent to have outside counsel lead discussion of legal disputes because case law is cutting back on attorney-client privilege where the briefing is given by inside counsel. In fact, attorney-client privilege as a whole in the corporate context is being eroded according to some observers. The introduction of an IP agenda item to the board could result in an unintended waiver. Consequently, corporate and IP counsel must carefully evaluate with management the best approach to briefing the board on IP. They also need to address the best approach for documenting IP agenda items in minutes and other corporate records and disclosures. IP audit letters to outside auditors deserve special attention.

Waiver of attorney-client privilege and/or work product immunity by briefings to the board can be problematic in patent disputes where willfulness or inequitable conduct is alleged, or in trade secret misappropriation actions where punitive damages are sought. Such waiver is decided under the case law of the court where the suit is brought and thus varies widely. Furthermore, there is typically no partial waiver. The patent context is particularly tricky. Generally, an opinion counsel is hired by the alleged infringing corporation to brief a reliance witness from management that the patent cause of action will ultimately fail. If patent liability is ultimately found, in order to shield the corporation from enhanced damages for willful infringement and/or for exceptional case attorney fees, the reliance witness must be deemed to have acted reasonably under the circumstances in accepting the professional advice of the opinion counsel.

Outside trial counsel typically briefs senior management in parallel, outside the presence of the reliance witness, about the strengths and weaknesses of their case. Trial counsel creates this wall so that opposing counsel will not have access to their trial strategy based on a waiver of attorney-client privilege. However, some courts, like the Delaware federal court, take an expansive view of waiver. Thus, in briefing the board in such cases, critical decisions need to be made on whether to provide the trial counsel perspective or the opinion counsel perspective, and how that briefing should be documented and reported.

Public company boards must now have a majority of independent directors under the stock exchange listing requirements. However, many such directors are executives in other corporations. Since the IP discussions could easily involve confidential information and strategy of the corporation, management and corporate and IP counsel must carefully consider whether a particular outside director should be excluded from learning specific confidential information and strategy.

In sum, there will always be a tension between briefing the board on all aspects of IP and the possible waiver and/or creation of a conflict of interest with the board or a specific outside director.

Recommendations and predictions

IP has increased strategic value for most companies, particularly in the technology sector. Not surprisingly, IP litigation has increased significantly in the last 10 years with a substantial increase in the size of settlements and judgments. The strategic importance of IP and the risk of liability from IP litigation exist at a time when potential liability exposure of directors has never been higher for failure adequately to oversee management. In certain circumstances, directors can face liability with a risk that indemnification may not be available. The recent settlements in the Enron and WorldCom cases are illustrative. In the WorldCom case, 10 former directors have agreed personally to pay US$18 million as part of a settlement of various suits brought by shareholders and bondholders of the company. The lead plaintiff in WorldCom, the New York State Common Retirement Fund, apparently made it a condition that the directors personally contribute to any settlement. In the Enron case, 18 of 29 former outside directors agreed to pay US$13 million of a US$168 million litigation settlement.

Consistent with this trend, the SEC has adopted a policy that any settlement involving individuals not only be paid by the individual but that, as part of the settlement, the person must agree to waive any right to seek reimbursement from his or her company or an insurance carrier. While both Enron and WorldCom represent egregious instances of board failure, directors should be mindful of this new trend. The emphasis in settlements holding directors personally liable, without recourse to the protections afforded by indemnification or D&O coverage, underscores the significant personal exposure directors now face.

Directors should consider several measures when serving on public company boards. First, directors should actively review the terms of their company's D&O liability insurance policy, preferably with the assistance of counsel. Historically, such policies have too often been left to management to negotiate with little to no director review. The risks are simply too high today for individual directors to not be aware of the policies a company has in place, available alternatives, and relevant exclusions and limits under current policies. In addition, directors, and particularly high-net-worth individuals, should consider a personal umbrella insurance policy prior to agreeing to serve on a board. This type of insurance is personal to the individual and could be used as supplemental insurance or, in the worst case, as a substitute if the company's D&O carrier is unwilling to contribute to a settlement. Use of such policies may be limited under certain circumstances, as investors and regulators may take the position that an individual must agree as part of the settlement to contribute personal funds.

Above all else, the primary focus of directors should be thoughtful and appropriate oversight of management. IP should unquestionably be subject to regular board oversight. The recent RIM case demonstrates how significant potential liability can be in the event of IP infringement, while WorldCom and Enron dramatically illustrate the extreme downside of oversight failure. Directors should not only understand their fiduciary obligations of care, loyalty and good faith to the corporation and its shareholders, but should also take the time and effort to provide the necessary oversight of management. Boards should seek counsel to ensure good process occurs and is appropriately documented. Finally, in the context of IP oversight, directors should regularly review their company's IP assets and related IP strategy as benchmarked against industry practice, engaging qualified counsel and other technical professionals to assist in the evaluation and protection of IP assets. The stakes are simply too high to leave the oversight of IP exclusively to management. ■

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